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TITLE:

Distress transactions in Spain. A brief investors' guide to financing, asset, share and debt deals.

Garrigues

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WORK INFORMATION AND BRIEF SUMMARY:

Title of the work: Distress transactions in Spain. A brief investor's guide to financing asset, debt and share deals

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Summary:

This work is a summary of the book "Distress transactions in Spain" written by Garrigues' law firm in 2019. It is a guide trying to offer investors a broader view about asset, debt and share deals.

Garrigues law firm explains from a professional perspective where Spanish firms looked for financing after suffering the deep 2008 crisis that really damaged their economic structure.

In the work I summarize the main mechanisms that were used and are that are being used yet to finance a firm in a distressed situation. Their main characteristics, advantages and disadvantages are explained in this report.

The main mechanisms used by Spanish firms were bank financing, company acquisitions both outside insolvency proceedings but also in insolvency proceedings, acquisition of part or the entire debt of the distressed company and loan portfolio acquisitions and property portfolio acquisitions and their main possibilities.

The book refers to the previous procedures, always linking them with the applicable legislation and the procedure to be followed in each case

INFORMACIÓN DEL TRABAJO Y BREVE RESUMEN

Título: Operaciones de socorro en España. Una breve guía para inversores sobre la financiación de acuerdos de activos, acciones y deudas

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Resumen:

Este trabajo es un resumen del libro “Operaciones de socorro en España” escrito por el prestigioso despacho de abogados Garrigues en 2019. El libro es una guía que ofrece al inversor una visión más amplia sobre las operaciones de activos, deudas y acciones.

Los autores explican desde una perspectiva profesional donde buscaron las empresas españolas la manera de financiarse después de la profunda crisis de 2008 que dejó su estructura económica gravemente dañada.

En el trabajo resumo los principales mecanismos que se utilizaron y que todavía hoy se utilizan para financiar a una empresa en una situación de apuros. En este informe se explican sus principales características así como sus ventajas y desventajas.

Los principales mecanismos utilizados por las empresas españolas fueron la financiación bancaria, las adquisiciones de sociedades tanto fuera de los procedimientos concursales como también en los procedimientos concursales, la adquisición de parte o la totalidad de la deuda de la sociedad en dificultades y las adquisiciones de cartera de préstamos y adquisiciones de cartera inmobiliaria y sus principales posibilidades.

El libro hace referencia a los anteriores procedimientos ligándolos siempre con la legislación aplicable y el procedimiento a seguir en cada caso.

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PRESENTATION OF THE WORK

This work tries to sum up the main information included in the book titled as "Distressed transactions in Spain" written by Garrigues law firm.

Garrigues is an international firm providing legal advice on business law and taxes. It was founded in 1941 and it has expanded until now, having more than 2,000 employees and operating in Europe, Africa, Asia, and America being present in thirteen countries. Moreover, it is one of the largest international law firms and it is included within the top law firms worldwide.

Their business is mainly based on experience, prestige, strict ethical principles, technical expertise, flexibility, and technological innovation. That is why understanding and analyzing the point of view of such a prestigious institution in that field, has made me understand more deeply how companies are financed and who they look for solutions to their economic problems

In the book that is under analysis in this report, Garrigues try to explain refinancing options for Spanish companies after the economic crisis of 2008. This work may help purchasers, sellers, and distress market advisers to use all the possibilities available to them because the Spanish distressed asset market is very attractive. Furthermore, for students, it can give a complete overview of what we have been studying but from a professional perspective so we can expand our knowledge and for sure, it will be very useful for our future career.

Moreover, companies facing economic problems is more common that one might think. Being up on the magnitude of the distress situation and having information on where the company should look for the best financing mechanism is crucial for rising from the unfavourable situation damaging the economic structure the less the better.

Each financing option is described very clearly making direct reference to the legislation applicable in each case. This makes easier the identification of the advantages and disadvantages of each possibility. For this reason, the book is very pleasant, and all the concepts are very clearly explained.

I. INTRODUCTION

Due to the recession of Spanish economy in 2008, distress transactions are nowadays a common feature of the legal landscape of Spain but also of other European countries. Distress transactions are those involving companies in difficulty, affected by excess of debt or whose assets were hit during the financial crisis.

According to the M&A context, distress refers to transactions in which at least one party is affected by a situation of tension that is, mainly, of financial nature. It is interesting to point out the difference between the terms “stress” and “distress”. A stress situation is one in which the inflection point (point of no return) is not imminent. Meanwhile, in a distress situation, an emergency has occurred, with all its consequences.

This book is not about making a precise and exhaustive examination of all the transactions, but the real aim is to share Garrigues’ experience in this field with interested readers in those topics.

II. FINANCING FOR DISTRESSED COMPANIES

Prior to the crisis of 2007 Spanish companies had a high level of leveraging (they had huge amounts of accumulated debt compared with their total equity). When the recession and the subsequent crisis arrived, those companies had to revert the situation selling part of their assets. This crisis was especially harmful for construction sector due to the "boom" in real estate assets.

Many times, it was impossible for companies to be able to repay their debts in the due time, so they agreed with banks to extend the repaying period. Although some firms could pay back the debt, some others could not meet their payment obligations and started a permanent refinancing process.

This refinancing process affected, obviously, to the financial system. This led to a change in the structure of the sector, many savings banks disappeared and "Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria (SAREB)" was created. This organization was built in 2012 with the objective of managing damaged assets owned by financial institutions with the purpose of reducing the risk faced by this kind of entities and transferring them to the Fund for the Orderly Restructuring of the Banking Sector (FROB).

At the same time, States' expenses increased, and incomes decreased due to lower tax revenues giving rise to an increase of public debt. This debt was mainly subscribed by financial entities and this affected their capacity to lend to private borrowers.

That is the precise moment in which private companies started to look for other financing alternatives.

I. Bank financing

1. *Transitory or "bridge" loans, secured, unsecured loans and their key aspects*

Bank financing for distressed companies is more common than what one might think.

Within this group of financing alternatives, the first one is a bridge loan. It is a usually short-term (usually less than one year) loan used until one person or entity removes an existing obligation or it is replaced by a longer-term loan. Those loans are characterized by the guarantees given to secure the payment and have high interest rates.

Although the guarantees are important, in not very distressed companies, sometimes both parties agree to limit the number and kind of guarantees offered because in that case, parties are involved in less formalities.

In the book those types of bridge loans are named:

- Cash bridge loan: Used to cover seasonal fluctuations in a business
- Restructuring bridge loan: To cover cash shortages due to a financial restructuring of the company
- Loan to own bridge loan: ahead of a finance provider or third party to acquire the company in difficulties
- Event bridge loan: Until a specific event occurs.

Financing a distressed company has two main problems: claw back risk and undertaking of financial obligations.

Claw back risk is analysed very deeply by financial entities when deciding whether to finance a distressed company or not. Banks usually carry out so called "stress tests". These tests examine the existence of some elements that could make riskier the repayment of the loan and the factors that could solve this hypothetical situation.

As regards to the liability that could arise for both parties when deciding to finance a distressed company or deciding to be financed by a financial institution, for the lender, the it is the so-called aggressive lending (helping a company that is completely lost) and for the borrower the problem comes when it is insolvent after taking financing being in difficulties.

2. *Nature of financing: fund provisions vs. financing of working capital, and categories*

When deciding how to finance a company, directors usually choose a financing plan that allows the company to access to liquid funding because those funds are easier to use. Another option is a plan in which the lender facilitates the management of the company's working capital. The main advantage of the latter is that it allows to payback the debt faster than what the contract sets.

Deciding the type of financing to offer depends mainly on the economic activity of the distressed firm, its need for immediate liquidity, the part of third-party loans and contracts that it has on its balance sheet and the payment track record with this parties and finally, the messages the distressed company transfers to the market, customers and employees.

The lender has the right to make a study of the borrower request and banks usually reserve the power to suspend the financing if a break on the agreement occurs.

3. *Regulatory issues: the rules on impairments, bank of Spain circular 4/2004 and its amendments*

Most of the regulations governing accounting rules for financial institutions are set on Bank of Spain Circular 4/2004. This Circular was amended in 2011 and later in 2012.

Due to the transparency requirements, Spanish financial entities have tried to reduce the financial burden borne by companies financially distressed but without damaging lending institutions both in the level of loan-loss provisions and the capital ratios required in relation to the assets received for debt repayment.

This is why Royal Legislative Decree 4/2014 appeared. Bank of Spain set standard criteria that classifies operations resulting from a refinancing agreement as standard risk operation. These criteria set that when a refinancing operation improves the possibility of collecting payment of a debt, this operation should be classified as one of standard risk. Moreover, if this improvement of the situation does not occur and future cash flows are not enough to repay part of the debt, the amounts owed will be classified as non-standard risk.

Consequently, to classify refinancing operations as standard risk ones, four level analysis is needed:

1) The borrower real current income must be enough and fully accredited
2) The viability plan, based on a payment plan, must be adjusted to debtor’s capacity to pay
3) The guarantees granted are important
4) Financial entities must continuously monitor the debt situation

Bank of Spain Circular 4/2016 amended Circular 4/2004 including the drag along effect term. This term means that financial entities will have to pay particular attention and provisioning all the loans taken by a same debtor when doubtful balance of the borrower is higher than 20% of the total financing that has to be paid back yet.[1] This measure was set to adapt Spanish legislation to IFRS.

Another amendment of the Circular 4/2004 was the elimination of "sub-standard" loans and the inclusion of "especially monitored" loans.

"Especially monitored" loans are those taken by insolvent companies but that are complying with the reorganization plan. A loan can be classified as "especially monitored" if:

- One year has passed since refinancing of the company
- The company has paid both the principal and the interest due since the refinancing started.
- An amount equivalent to the amounts due prior to the refinancing has been paid
- The party does not owe amounts payable for over 90 days.

As we have seen, classifying refinancing debt can be sometimes difficult, that is why important rules to classify debt appeared:

- Rule 100: Initially, the highest ranking that can be reached by refinancing operations is "normal risk on the watch list". But, if special requirements are met, it could be assigned as "normal risk".
  However, if certain clauses or an inadequate plan exists it will be classified as "non-performing"
- Rule 110: Risk of insolvent debtors but that have agreed a creditors' arrangement will be classified as "non-performing".
- Rule 112: Operations that follow the requirements of drag along effect, will be classified as "non-performing".

4. *Monitoring and supervision covenants: the risk of the facto directorship.*

[1] ABC. 2020. *La Banca Provisionará Todo El Crédito A Clientes Con Una Morosidad Del 20%*.

When financing a distressed company, a usual problem is verifying whether the debtor is using the money for the agreed purposes and if it fulfils the conditions set in the financing agreement. It is for that reason that lenders will be granted with powers that give them inspection rights (accounts, examination of the statements, regular valuation of collateral…) or with more specific mechanisms (guidance to the financed party on how to allocate funds, refusing a drawdown request when it considers necessary…).

Many times, lenders do not know until which point, they have to apply these powers. The strict monitoring of the borrower makes sometimes to exert an influence on the business. This power should always differ from a de facto directorship because the lender should not supplant the debtor's management in any case.

II. Alternative financing

Spanish businesses have traditionally depended on banking financing but, there exist a large list of non-banking financing alternatives:

- Issue on capital markets:
  - Fixed income securities (bonds, promissory notes…)
  - Alternative Fixed Income Market (MARF)
  - Variable income securities (stock market or MAB[2])
- Securitization of assets
- Crowd funding
- Venture capital or private equity operations
- Direct lending

Although there are many alternatives, most of Spanish companies do not have access to those types of financing due to, mainly, size limitations. That is why in 2008, MAB was funded.

MAB is a multilateral trading system that has 40 listed companies and it offers for smaller size companies the possibility of being listed in the markets. Listing requirements in MAB are not so strict as the stock market ones. Although MAB seems to be a possibility the truth is that it is not so used by companies.

[2] MAB: Mercado Alternativo Bursátil

Regarding fixed income securities, the introduction of the MARF should allow more companies to get finance by issuing fixed income securities. Again, the access requirements to this market are more flexible than those for the official regulated markets.

As regards to asset securitization, it is a complex process and consequently, it is more used by financial institutions that by any other company because of high level of costs involved.

Crowd funding is another possibility. This was regulated for the first time under law 5/2015 but Garrigues consider that this instrument needs to mature to check if it could be a reliable source of financing for distressed companies because it is too “new” yet.

Focusing now on venture capital and private equity contributions, those sources of financing are mainly used by institutions that provide financing to companies that take part of their portfolios or to invest money in “Profit Participating Loans”. Those are loans which return is directly linked to the profits obtained by the debtor company.

Finally, direct lending needs a deeper analysis and explanation because it has offered distressed companies more opportunities.

Direct lending is mainly provided by debt funds. In 2014, debt funds appeared as new players of the financial market in Spain. Those are usually mergers of companies that create a fund to lend money to Spanish SMEs. At the beginning, the market was formed by international funds but later, Spanish firms started also to lend money. Due to the crisis, banks lent money with higher rates and with shorter deadlines. Debt funds do not offer cheap financing, but they offer deadlines between three and seven years depending on the purpose of financing. When considering it as a form of financing, a borrower should weigh factors (price, terms, restrictions, guarantees…).

Many of the advantages of debt funds are that offer investors alternatives to banking deposits, they are more specialized, so those channel resources to specific needs. Moreover, debt funds are also a source of spreading risk.

Funds are usually offered for transactions that banks consider unprofitable. Funds operators engage in “credit investments” meaning that they provide financing in primary market or invest in existing debt instruments in the secondary market. However, there are investors willing to take control over the debtor (“loan to own”). They agree to relief the debt the borrower owes if a third party provides this financing needed.

III. COMPANY ACQUISITIONS

A business can be acquired through the acquisition of its assets and assuming all its liabilities (direct acquisition) but also acquiring its shares (indirect acquisition).

Acquiring all the assets is complex, risky and it has tax costs (goodwill or capital gains), therefore many of the businesses are acquired through its shares. But when insolvencies arise, the acquisition of assets becomes important also because it is a formula that ensures that creditors recover the debt.

I. Acquiring a business outside an insolvency proceeding

A business that is not yet insolvent can be acquired by a bilateral process (only one interested buyer negotiates with the owner) or a competitive one (several buyers negotiate with the owner).

Competitive process is characterized by:

1) All parties interested are identified and contacted
2) A non-disclosure agreement (NDA) with all interested parties is executed.
3) Parties that have signed the NDA are sent:
    a. A "process letter" with information about the transaction, documentation and information that will be provided, key dates,
    b. A confidential memorandum (CIM) containing detailed information about the company
4) Parties begin their due diligences
5) Non-binding bids are submitted
6) Some bidders are selected to take part of the next phase.
7) Another "process letter" is provided (contents of binding offer, structure, key dates for the second phase…).
8) Selected bidders are given additional documentation
9) Draft of the sale purchase agreement (SPA) is provided to bidders that can propose changes
10) The binding offer is submitted together with the SPA
11) Seller of the business and bidder negotiate and sign SPA
12) Transaction agreements are signed

13) The deed of sale is notarized

On the other hand, **bilateral processes** are simpler as in those only the seller of the business and one possible bidder are involved:

1) A document describing the transaction, key dates, exclusivity, and confidentiality commitments is signed by the parties
2) Performance of the due diligence by the purchaser
3) SPA and other documents are negotiated and signed
4) These documents are notarized.

When the acquired company has debt that will not be able to be repaid, the acquisition involves talks with the creditors to negotiate the amount of funds to be invested in the company, the new terms of the sustainable debt (amount that can be repaid) and also the way unsustainable debt is treated. Usually, the new investor acquires this debt and it becomes subordinated debt or capitalized debt.

For both processes, bilateral or competitive, a SPA is needed including warranties and taking the obligation of the seller to assume liability in the event those warranties are not true or accurate.

The fact that the seller could become insolvent after selling the business can give rise to some problems such as the fact that purchasing from a seller that may become insolvent includes claw back risk of the transaction. Moreover, seller's insolvency can provoke it not to comply with the contractual obligations. Furthermore, when acquiring a company declared insolvent is difficult to implement mechanisms to hold the seller liable.

II. Claw back actions: in particular, structural modification operations carried out on distressed busines before and insolvency order

When an investor wants to acquire a distressed company, it usually carries out a legal analysis to identify possible future risks that could affect the transaction. During the last years, this analysis includes the corporate restructuring transactions that may have to be done at distressed companies. Several courts have discussed the possibility of reversing these transactions carried out within the two years prior to a declaration of insolvency.

According to Garrigues' opinion, structural modification transactions are valid and can be a way of overcoming a distress situation. They can be very useful if they involve restructuring corporate groups.

In any case, this process faces twofold risk:

- That the structural modification has no effects on the insolvency proceedings
- Possibility that the structural modification may be subject to claw back risk

III. Acquisitions in insolvency proceedings

During the acquisition of a distressed company, the buyer will concentrate on employment and tax issues since the buyer will want to avoid employment and tax contingencies when acquiring a business. Acquiring a business consists on assuming liabilities with Spanish Social Security and assume liabilities for three years after the transfer of any employment obligation not met by the acquired company.

1. Acquisition during the common phase: article 43 of the Spanish insolvency act

Art. 43 SIA[3] allows the early disposal of goods and rights, although it makes the operation conditional on a prior authorization from the courts unless one of the following exceptions is met (Art 43.2 and Art 43.3 of SIA):

- Acts of disposal that the insolvent company considers indispensable to secure the feasibility of the business or to continue with the insolvency proceedings. The Court must be informed and attached a justification of this.
- Acts of disposal of assets that are not necessary for the continuity of the activity when offers coincide with the value of those assets in the inventory. Again, the Court must be informed and attached a justification.

It is considered that businesses are sold more quickly and at a better price when are transferred in early stages of the insolvency proceedings. Investors prefer buying during

[3] SIA: Spanish Insolvency Act

early stages rather than in liquidation phases because later, many conditioning factors appear (creditor consent, not preliminary liquidation plan…).

2. *Acquisitions by ordinary arrangement: particularly a business assignment*

Although most assets of distressed companies are disposed during the common phase, it is also possible to acquire assets during the arrangement phase.

SIA originally prohibited the assignment of assets as a way of paying creditors, but SIA reform Law 38/2011 allowed certain creditors to acquire an asset put as security. In practice this is difficult because SIA prohibits the assignment in lieu of payment of any assets that are necessary for business activities to continue.

There exists another interesting possibility to acquire a distressed company that consists on acquiring a business through a business assignment. A party acquiring the activity does not assume all the debtor's assets and rights but only one or more business units. This is a trilateral arrangement between the party proposing the arrangement, the party assuming the rights and assets and the creditors.

Courts have concluded that the acquisition of a business through an assignment will entail an obligation to pay any legally required claim (Social Security and employment related).

3. *Acquisitions through an advance proposal for an arrangement*

A distressed company can be also acquired through an advance proposal for an arrangement. It can be formalized at a very early stage of the insolvency process.

The advance proposal of an arrangement includes taking on the company's insolvent business to be submitted together with the petition for insolvency whenever the investor:

- Has completed the due diligence process on the distressed business
- Is clear about the degree of responsibility it has in relation to the pre-petition or post-petition claims
- Has enough backing to meet the court requirements (it has to assume one tenth of the liabilities instead of assuming one fifth if the advance proposal would be submitted after the insolvency petition).

From Garrigues' point of view, advance proposal of an arrangement offers two clear advantages:

- Acquiring a distressed company at an early stage with specific details on how much of the business will be taken and court authorization will make possible to align interests of all stakeholders (investor, insolvent party, suppliers and employees).
- In case of an interested party to object the arrangement, the court can order an interim injunction that would ensure compliance with the arrangement under the conditions the court would determine.

4. *Acquisition during the liquidation phase*

4.1 General issues

As regards to the liquidation phase, there are two main current matters:

Purchaser's subrogation to the seller's Social Security debts:

When investors are interested in acquiring one distressed business they want to know if they will have to subrogate any debts the insolvent business would have with Social Security.

Art 149.4 SIA establishes that a party acquiring a business during the liquidation phase must assume responsibility for any Social Security debts.

The acquirer's liability should be limited to the debts the seller has on specific employment contracts to which the acquirer is being subrogated. It means that the obligation will depend on the number of contracts that are transferred, the acquirer will pay only those obligations that are transferred.

According to the judgement of Barcelona Commercial Court No. 9 on 24 July 2015, successions that occur in insolvency proceedings are entirely governed by Spanish Workers' Statute so the acquirer should assume labour debts except for the proportion covered by FOGASA.[4]

[4] FOGASA: Spanish Salary Guarantee Fund

But, most of the magistrates and judges have found that when selling a business during insolvency proceedings the judge handling the case has the power to decide whether the acquirer has to pay Social Security obligations or not and in which degree.

Purchaser's ability to subrogate to any contracts

According to SIA, an acquirer is allowed in an express liquidation process to select the contracts that will be terminated and those that it will maintain after the acquisition.

Lately, Art 146 bis allowed the purchaser to be subrogated to the distressed company contracts with no counterparty consent required. This article also establishes that judges have no jurisdiction to exercise any administrative control over the objective.

Regarding public contracts, SIA establishes that the assignment will not be automatic. Those will be made according to administrative legislation that permits assignment if the contract was not originally signed based on the special qualities displayed by the awardee and if the assignment has no impact on competition

Moreover, the purchaser must be solvent, and the agreement must be recorded in a public deed.

4.2 Acquisitions during liquidation using fast track procedure

This section explains the difficulties a company must face when using the "express liquidation". Those obstacles, that slow down the process are:

- It is impossible to transfer a business without having opened a term to submit offers.
- The tendency of receivers to prepare liquidations plans different from the one proposed
- Use of deadline extensions for the issue of the plan and the transfer report
- Frequent request for postponement to submit an inventory list of provisional creditors
- Some receivers claim that the plan cannot be implemented until the secured claims have first been fully settled
- Revision of the price set by the acquirer

The solution for those problems requires legislative reforms or case law interpretations that could be appealed.

IV. ACQUISITION OF CORPORATE DEBT

From the beginning of the crisis, many investors have shown interest in acquiring distressed companies' debt. Those instruments are known as non-performing loans (NPLs).

NPLs include loans affected by non-payment but also those that require a lower quality, or lower standard qualification. This market has evolved more slowly in Spain than in other countries due to differences on prices offered by buyers and sellers, loss on voting rights or the length of insolvency processes. That can also be due to the fact that other countries impose much more regulations. With SIA, legislators have tried to amend all those problems.

For distressed business, selling debt may be interesting for several reasons such as:

i) Providing a way out of difficult situations
ii) Allowing capital and resources to be devoted to more productive activities
iii) No need of invest in the development of work out capabilities
iv) Making profits in case debt's book value is lower than its sale price
v) Dispose of low rated debt
vi) Generating liquidity
vii) Improving capital ratios

Small businesses usually sell its debt in the form of NPL portfolios. Meanwhile, larger borrowers usually prefer sale of single names because accounting regulations penalize portfolio sales, portfolio sales include a due diligence that limits the parties that might be interested and, moreover, portfolio sales are very costly, and a high ratio of processes fail.

I. Purchase of distressed debt

Again, as it happens when a business is sold, corporate debt can be transferred using competitive or bilateral process.

Bilateral process follows the next steps:

1) Signing an NDA[5] and submitting a bid pricing letter including:

[5] NDA: Non disclosure agreement

    a. The loan to be transferred
    b. The deadlines for each stage
    c. Sale price
    d. An exclusivity and non-shop undertakings
    e. Breakup fees
2) Agreement between the parties
3) Sending by the seller to the buyer a proposal and documentation of the debt traded
    a. Trade date (day from which the buyer will assume risks associated with the loan)
    b. The settlement to transfer
    c. Breakdowns of the loan or loans
    d. Price
    e. Interest procedure
    f. Costs associated with the transfer procedure
    g. The way the transfer will be achieved
    h. Closing mechanisms
    i. Compensation due in case of delay in settlement
    j. The break-up fees
4) Buyer's due diligence
5) Negotiation of the trade confirmation
6) Negotiation of transaction documents
7) Seller and buyer's acquisition of authorizations
8) Settlement
9) Notification of the transaction to any involved parties

The other way of transferring debt, **competitive process**, follows these steps:

1) Execution of an NDA by all the parties involved
2) Providing by the seller of all the available documents related to the debt to be transferred
3) Submission of binding offers
4) Execution with the chosen investor of the agreements and any other transaction documents
5) Notification of the transaction to any affected parties

Regarding debtor's consent, it did not use to be a requisite, but it has become increasingly necessary. Moreover, sometimes it is necessary the acquirer to be a regulated financial institution but traditionally it is enough if it is a tax resident in a "friendly" country. When the acquirer is not resident in a tax heaven the transfer is guaranteed by a multi-purpose mortgage meaning that it requires the beneficiary of the guarantees to be a regulated financial institution.

It is also odd that debt cannot be transferred to institutions written in a blacklist due to prior disagreements with the debtor or its shareholders.

The following sections include the most important factors regarding due diligence, legal rules applied when assigning a loan and differences between loan transfers and participation agreements.

1. Due diligence

A due diligence process consists on determining the value of the debt that is going to be transferred. For doing so, an analysis of the following items is needed:

i) All facility agreements, hedging agreements or intercreditor agreement
ii) All security agreements and information about assets that will be securities
iii) Annual accounts of several years of the debtor and the guarantors

Knowing the amounts that may be claimed by the purchaser of debt requires knowledge of the issues financing institutions would worry about in debt restructuring processes. Acquisitions can break down if the investor cannot acquire a percentage of debt sufficient to prevent the formation of majorities.

2. Legal regulation

Spanish Civil Code contains detailed rules describing what is mandatory and what is not:

i) Debts taken as the result of an obligation are transferable subject to the law unless otherwise agreed
ii) A debtor that had agreed to the creditor's the possibility of assigning rights to a third party may not claim any set off against the assignee.
iii) If the creditor notifies the assignment and the debtor did not consent, the debtor may claim the set off debts made to the original creditor prior to the assignment but not those dating from after it.

iv) When an assignment is made without the debtor's knowledge, it can claim the set off of any credits made prior to the assignment plus those made afterwards.

Spanish Civil Code also establishes that a debtor that had paid the debt before becoming aware of the assignment, will be free from any obligation.

Moreover, it has to be clarified that the sale of a debt includes all related rights such as mortgages, pledges or guarantees.

When selling a loan, the seller in good faith is responsible for the legitimacy of the loan, although it has not responsibility on the debtor's solvency unless previously known. Those terms and situations are supposed to be set out in a loan assignment agreement.

Article 1532 of the Spanish Civil Code related to loan portfolios, sets that a party selling rights, revenues or products at a price must assume liability and legitimacy of the entire package but for example, if some of the loans cannot be recovered, there is no liability for the seller.

When the portfolio sold includes a litigated loan, the debtor can cancel the sale paying the assignee the price it had paid, and all costs related with the acquisition under these conditions taking always into account that the loan must be a litigated loan, it must have been assigned or transferred to a third party and that the debtor must exercise the right within nine days.

Litigated loans are those that:

i) They cannot enjoy real status without a final judgement. A loan can be qualified as litigated if a court action had been brought not only to dispute whether or not it existed but also the nature of the right or credit, its scope, the amount owed, the type of loan or any of its terms.
ii) A litigated loan does not cover any legal relationship that has ended or reached completion. This means that a loan losses its litigated status when there is no uncertainty regarding its successful outcome
iii) Its acceptance of existence and enforceability is pending or disputed
iv) The debtor refuses to pay

3. *Transfer of loans vs. Sub-participations*

One the one hand, there exists the transfer of loans. When a credit right is transferred, the creditor assigns its position to a new debtor's creditor. The new creditor can negotiate with the debtor the modification of the terms of the debt.

On the other hand, sub-participation in a loan means that the original creditor continues being the formal owner of the loan while the party taking the sub-participation acquires the right to receive an amount from the creditor in proportion to the share in the loan, it may not negotiate with the debtor and it has no relationship with it, meaning that if the debtor becomes insolvent it has to take part in the insolvency process through the lender of record. Moreover, it enters into an agreement with the creditor meaning that it is exposed to the risk of the lender of record becoming insolvent.

Taking that into consideration the participant is in a position similar to one it would assume if it acquired the entire loan except regarding any possible problems with the lender of record's solvency. The sub-participation agreement will say how decisions are taken by the different participants.

II. The Spanish insolvency act and the acquisition of debt

1. *Impossibility of petitioning for the debtor's insolvency within six months of acquisition*

According to Art. 19.4 SIA, a creditor can file for the insolvency of its debtor, but this is not possible when the creditor has acquired the loan during the six months prior to the insolvency filing, as a result of an inter vivos act, under individual title and after its maturity.

The acquisition by assignment of a loan that meets the four prior requirements will block any petition for the debtor's insolvency until six months later from the date of acquisition.

It is doubtful whether the previous restriction will apply when the loan is inside of a loan portfolio because portfolios usually include loans selected by the seller and not by the acquirer. In these cases, it does not seem the terms of the acquisition are very unfavourable for the seller, nor that the buyer aims to damage one or more specific debtors, because the debtors included will necessarily depend on the selection the seller makes. That is why this regulation is questionable.

2. *Acquisition of debt from parties that are especially related to the debtor*

SIA considers an especially related person someone that buys debt from a party related to the debtor within two years prior to a declaration of insolvency.

From Garrigues' point of view, debt acquirer should prove that the extension of the harmful effects (subordination of the acquired debt) is meaningless. This way, one could avoid subordination and rise above any suspicion of insider dealing, if the acquirer did not want to take advantage and was not favoured by insider status that the transferor actually did have, the loan was transferred according to market conditions and it was transferred as part of the transferor's and the transferee's normal business activity.

3. *Acquisition of insolvency debt and loss of voting rights in the arrangement with the debtor: latest trends*

Art 122 SIA is related to debtors without voting rights. The limitation of voting rights comes into effect when the party acquiring the claim after insolvency has been declared has the status of subordinated creditor and particularly the status of a party especially related to the debtor. Those lenders can exercise their voting rights related to other loans but not to previous ones.

This regulation has been under debate and Spanish legislation is very close to accept the corrective reaction of US Bankruptcy Code that establishes that the judge is who can use a designation procedure to exclude any votes that were not cast or obtained in good faith.

V. LOAN PORTFOLIO ACQUISITIONS (NPLs)

One of the main mechanisms banks have been using recently to reduce their leverage levels is the sale of NPL portfolios. At the beginning of the financial crisis of 2008, the majority of those NPLs were unsecured because mortgages book value was higher than the price investors were willing to pay for them, so this kind of loans were not traded.

But now, mortgage debt sell is as frequent as that of unsecured loans and the size of the transactions is larger. In 2018, commercial mortgages were the preferred option.

As regards to unsecured debt, the majority of portfolio sales are made by banks but also by sellers that purchased this debt during the recession and are now divesting.

I. Main legal issues to consider when acquiring loan portfolios

Loan portfolio sales are not usually bilateral transactions, competitive processes are preferred. When selling a loan portfolio, during the period prior to the due diligence phase the seller performs an intense activity. It gathers all relevant information on each of the loans forming the portfolio with the help of an VDR platform. [6] After that, the seller informs potential bidders that it wishes to sell the loan portfolio and it distributes four documents: the teaser, the NDA, the CIM[7] and the process letter.

The teaser is a blind commercial and non-binding executive summary. It sets the main characteristics of the portfolio (number of loans, balance, maturity times, securities…).

Moreover, after an NDA has been negotiated, the seller will provide the investor with the CIM. It provides more detailed information as the seller's identity, characteristics of the portfolio's loans (collaterals, date of the first default…). It also says how the seller has managed the portfolio and the deadlines of the process. As obvious, the CIM will set a cut-off date for the portfolio that will coincide with the end of a month to facilitate the monitoring and identification of interim payments. [8]

[6] VDR: Virtual Data Room

[7] CIM: Confidential information memorandum

[8] Interim payments are those made between the cut-off date and formal completion of the sale-purchase transaction. Usually they are assigned to the buyer.

Finally, the process letter sets out the way and deadlines within which the investors have to submit the offers, the requirements set by the seller to check that the bidders are not side lined, the dates on which bidders will have access to sensitive information to make their analyses ,the dates on which the SPA will be made available and the way transaction will be completed

1. Due diligence

Once investors are interested in taking part of the process, the seller provides the investor with the access to the VDR for carrying out its due diligence.

Opening the due diligence phase is one of the most important parts of the loan portfolio sale process. With the information provided by the seller, the investor must be capable of assessing the value of the loans. If the loans included in the portfolio are unsecured loans made to individuals or SMEs, the valuation will be statistical. It takes into account the age of the loans, number of default payments, average size of the loans and other variables. This valuation is made based on models developed by credit servicers and investors from their experience. In the case of being secured loans, valuation is usually based on the value of the collaterals and the time frames within which these assets could be repossessed and sold.

Assessing the value of loans to large size companies is more hand-crafted process. It means analyzing the debtor's solvency, examining the possibility of reaching an agreement on payment, enforcing potential guarantees and thinking also in a solution in case of debtor's insolvency.

Investors can ask for experts help when engaging in due diligence process. Financial advisers are very useful when performing or sub performing loans are included in the package because expectations of recovery in this case depend on economic health of the industry, in the viability plan…

When assessing a loan portfolio, the buyer's adviser can find several risks:

a) the existence of financial instruments with drawdown risk that tends to arise during assignment positions
b) the existence of financial instruments that cannot be assigned due to legal restrictions

c) the existence of financial instruments that have been signed in the two prior years to the planned purchase date or the counterparty's declaration of insolvency
d) the existence of litigated loans for which the debtor may possibly enforce a right of redemption
e) the relative weight the assigned loan has on the overall debt that is being transferred
f) the existence of loans affected by subordination issues in the event of the borrower's subsequent insolvency
g) the existence of loans subject to reinstatement in the event of a subsequent insolvency
h) loans affected by grounds of termination or early maturity that have not been accelerated by the seller
i) the existence of loans secured with real estate assets when the security is of a rank lower than declared by the seller
j) the possibility of some of the clauses of the agreements being declared abusive

For minimizing these possible risks, the buyer has two options: it can assess if those are low, medium or high level risks and price it or it can enter into negotiation with the seller to classify the loans affected by these risks as "excluded loans" or "defective loans". Excluded loans will usually not be transferred while defective loans can be dealt with in several ways in the SPA.

On the other hand, the seller's adviser has also to assess some risks:

a) The buyer's solvency has always to be considered
b) The buyer citing confusing or incorrect information or lack of documentation is also a risk
c) The return of excluded loans or defective loans
d) Sellers usually worry about transition costs that are human and material resources that the seller might have to make available to the buyer once the sale is formalized.

2. *Sale purchase agreement (SPA)*

Usually the binding offer includes a draft of the SPA and it is more usual to ask investors to submit the SPA in the second stage to discuss any possible changes.

On the one hand, advancing on the negotiation of the SPA has some advantages for the seller such us that the seller can learn which representations the investor wants to obtain as guarantees and the seller can get an idea of the financial conditions the investor wants to establish and then approximate the price set for the portfolio.

But, on the other hand, it also provides benefits for the potential buyer: SPA will allow to point out any grey areas that the investor has identified at a point in the due diligence process and this will force the seller to provide more information about the portfolio. Furthermore, the changes made by the investor in the SPA will allow it to give the seller an impression of professionalism and rigor.

Meanwhile, one of the most relevant disadvantages is that early discussions in the SPA leave the investor with few possibilities of last-minute changes.

As regards to the structure of the agreement, the classic structure includes first, a description of the companies signing the agreement, the purpose of it and the basis for the competitive process, with a clear establishment of the price. After that, the price of the portfolio and the agreed method of payment are included. The price will be set for the whole portfolio although usually companies include a separate price for the different loans. It is common in mortgage portfolios sells.

Next, the method of payment and the source of the funds are included. Any amount received by the seller between the cut-off date and few days before the formal transfer is deducted from the price payment.

The following contents of the SPA are the representations by both the seller and the buyer. Some of the following clauses are usually included:

In the part of the seller:

a) The seller is the holder of the loans being assigned
b) The security being transferred is of a certain rank
c) The security has been validly put in place and not involved in insolvency proceedings
d) There are no claims from which a repurchase of litigated loans could be brought by the borrower
e) The seller has not agreed to refinance the loans being transferred
f) The loans bear no charges or encumbrances
g) The seller will not offset amounts owed by the borrower

From the buyer's side those are:

a) It has skills to manage the loan portfolio acquired
b) It has deeply analyzed the portfolio and it is satisfied with the information provided by the seller
c) It limits the liability of the seller to certain parameters
d) It will assume responsibility for certain tax costs incurring during the transaction

The parties will then reach an agreement. Then, the signing and public recording of the loan assignment agreement are complete simultaneously.

Closing is the next step and it will happen days or weeks after signing, however, in case the buyer needs some time to get the funds to pay for the portfolio or in case some of the loans transferred are subject to authorization from the FROB the transaction can not be closed until the exercise of this right has expired.

Finally, SPA will end including some clauses on confidentiality, notification, costs, taxes, applicable law, expenses, jurisdiction…

3. *Registration and enforcement of mortgages linked to the loans sold*

A significant procedure is the registration in the buyer's name of the real estate or other assets offered as security on the loans transferred.

Article 540 CPA requires evidence that the buyer is the successor to the title that corresponds to the seller.

However, there are two situations in which the court might not allow this succession. The first one is when the buyer has not accredited entry of the security in its name in the corresponding registry. It might be due to high registration costs so that both parties agree that the seller will pursue the case until possession of the asset occurs. Although nowadays, Spanish courts do not accept that one creditor that has not recorded its security in the registry has legal standing to initiate a mortgage foreclosure. Secondly, courts sometimes reject succession if it is shown that the assignment of the loan harms one of the parties' position.

II. Management of the loan portfolio that has been sold: credit servicing

Credit servicing are agents, most of them are special divisions within banks or controlled by distressed investors, that specialize in the management of distressed debt. Through them, distressed investors outsource the management and collection duties of the debt included in the loan portfolios acquired.

The relationship between investors and credit servicers is regulated in SLA ("Loan servicing agreement"). In these contracts it is usual to include fixed payment for specific services plus variable payment that will depend on returns achieved in the management of the portfolio.

Moreover, the SLA also includes mechanisms to protect both parties interests such as:

- The credit servicer cannot subcontract. It must provide the services with its own resources.
- The credit servicer must present an initial business plan with the investor. The plan will set the strategy for recovering the loans, time period and estimate costs.
- A pledge to report to the investor with regular information is needed. The investor can continuously monitor the work carried out by the credit servicer
- The SLA must include a right of withdrawal for the investor in case the credit servicer breaches its main obligations
- The right to compensation for damages as the result of events that can take place after the SLA termination

It is also usual to include no exclusivity clauses so that the credit servicer can also work for other investors, the exemption of liability and the duty to pay compensation in case of major force and the fact that the servicer can terminate the contract at any time offering a minimum advance notice.

III. Personal data protection regulations

As it seems obvious, when a loan is transferred, also debtor's personal data are transferred. Their protection is very important when selling portfolios of loans that are granted to natural persons and it is less important when the debtors are companies. Personal data protection regulation is included in GDPR [9] and LPPD[10]

1. *Lawfulness of processing*

Any company or professional processing data in any manner must comply with all the principles of GDPR. If the processing does not meet those conditions, it is unlawful and therefore prohibited.

As refers to transfer of undertaking, business, or similar assets, according to Art 21 LPPD it is lawful to disclose the data necessary to complete such transfers.

2. *Information to debtors*

As previously said, the first step is checking the compliance with GDPR. The second task is to inform data subjects about the processing activity. Each individual debtor included in the loan portfolio should be notified about aspects listed in Art 13 GDPR such as the purposes of processing, legal basis, legitimate interests, periods for which personal data will be stored and some other legal aspects regarding the treatment of personal data

The notification should be done within a reasonable period after obtaining the data, but al latest within one month.

3. *Consequences of non-compliance*

No complying with personal data processing obligations can have huge costly consequences for both the assignor and the assignee. Fines can reach the higher of €20 million or 4% of the undertaking's annual turnover. This is why, usually, SPA stipulates how debtors and guarantors are notified, costs and, since May 2018, provisions regarding compliance with GDPR are included.

4. *Security measures*

Data controllers and any data processors must adopt measures to guarantee the security of personal data belonging to the debtor and its guarantors to prevent this data from being altered, lost, processed, or accessed by unauthorized persons.

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[9] GDPR: General Data Protection Regulation 2016/679 approved on 27 April 2016 and applicable since 25 May 2018
[10] LPPD: Spanish Organic Law 3/2018 on the Protection of Personal Data and Guarantee of Digital Rights of 5 December 2018

5. *Data processing agreements*

Processing data to third parties must be regulated under an agreement that has to be presented in writing or some forms that gives proof of the agreement and its content.

6. *Insights into the future*

Personal data contained in any of the databases can be extracted using properly algorithms and it has immense value so, the more sophisticated the tools to process the data, the stronger are the protection requirements.

IV. Funded participation agreements

In Spain, the assignment of participation in loans has not been as popular as in some of its neighbours. But that is true that some loan portfolio sales are carried out as a participation agreement, that is, in return to an amount paid an investor acquires the revenue streams for a loan portfolio while management of the portfolio corresponds to an institution hired by the party that hold the title of the loans (lender of record) but it can be also hold by the participant. Moreover, from an agreed cut-off date, the participant will assume all the risk inherent in the portfolio.

These transactions are similar to a loan portfolio sale but differing in the concept of lender of record that in the case of funded participation agreements it cannot do anything that impairs the value of loans and it has also to submit the instructions of the participant

Moreover, in these operations there are no requirement to notify the debtor about the transaction until formal ownership is transferred because the lender remains being the same and borrower's data has not been transferred.

In funded participation agreements it is possible for the participant to acquire formal title of the loans. These acquisitions must be notified to the debtor and in case it includes some loans subject to legal proceedings, to the courts.

VI. PROPERTY PORTFOLIO ACQUISITONS (REOs)

During the early stages of the recession, REOs were not very traded due to the gap between their net book value and the price investors were willing to pay for them, but now there are very traded, even more than NPLs.

The sale usually takes form of competitive process. The key contractual documentation is the SPA, the SLA, and when financing is going to be used, the financing documents.

The structure of the SPA is similar to a loan portfolio purchase agreement. In this case, the seller will try not to assume liability for any problems the investor may identify when reviewing the documentation provided in the VDR.

The SPA will also go into detail regarding the documentation relating to properties, paying the charges associated with their transfer and the registration of the transfer at the Land Registry.

VII. ACQUISITION FINANCING AND SECURITIZATION

This section refers to the context and terms in which distressed operations have been financed based on Garrigues' experience in the last years in NPLs Spanish market.

I. The facilities

Spanish law does not prohibit or restrict financing of the acquisition of NPLs. Moreover, there are no precedents of any litigation brough by debtors against NPLs acquisition lenders on any grounds.

In any case, financing documents always include a compliance with laws provision undertaking because the borrower and obligors are obliged to conduct their business in accordance with all the applicable laws. The lenders can terminate the agreement if any illegal conduct is detected.

1. General categories of the terms in the financing

In the facility agreements LMA provisions such us conditions of utilization, interest periods, taxes and indemnities are included and also sector specific provisions related to NPLs portfolio.

2. The facilities

The financing structure usually includes term loan facility to fund, directly or indirectly, and, if the asset owner and the borrower are not the same company, the total acquisition cost of the portfolio.

However, as NPLs generate income with fluctuations difficult to predict, there are periods in which the cash generated is not enough to meet interest payments (Interest Shortfall Amount). This is why sponsors usually ask that any shortfall will be rolled over next interest period. So, there might be two facilities: Facility A (the main one) and Facility B (to cover any shortfall).

3. Repayment and pre-payment

As the cash flows expected from the portfolio can not be perceived in a pre-ordained calendar, the sponsors expect from the lenders a very flexible repayment schedule. This is where a very important term arises: the commercial agreement will define that the part of the “Available Income Funds” remaining after expenses, fees, interest… will be applied to repay the principal amount.

Another determination is if the facilities are voluntary early repayable with or without any “Make Whole Amount” (typically the margin on the repaid principal times the period left up to “Make Whole Cut-Off Date”, that is the agreed date in which voluntary repayments are subject to make the whole payment).

4. Interest and default interest

In this section there is nothing relevant to be said other than what has already been said in section VII I.3 regarding Interest Shortfall Amount.

5. Representations

The more typical representations are those similarly found in acquisition finance such as the completeness of the acquisition transaction documents and truthfulness of the structure chart.

6. Information undertakings

As regards to information undertakings, the more specific ones are reporting, having a business plan, that will be delivered annually, and valuation because the borrower might need to present and independent appraisal every one or two years.

7. General undertakings

The following undertakings might also be included to adapt the financial documents to the specific characteristics of the transaction:

- i) Compliance with, preservation and enforcement of rights under the acquisition transaction documents
- ii) Restrictions on appointment of asset managers and termination and new appointment of asset manager
- iii) Restrictions on appointment of credit servicer and termination and new appointment of credit servicer
- iv) Strategy agreed with asset manager and credit servicer to meet obligations under finance documents
- v) Obligors to try that asset manager and credit servicer observe servicing standards and to enforce asset management agreements

vi) Restriction imposed on property or portfolio loans sales below certain prices normally expressed as a percentage of the initial allocated asset or loan amounts which percentage may differ depending on the actual loan cost.

vii) Another restriction is that the loan agreement may provide restrictions on the ability of the purchaser to waive the rights under the documentation of the loans in the portfolio or the securities

viii) To keep the bank accounts in the agreed terms

ix) The parties might agree that if the securities do not fall on a specific proportion of the loan, the obligors will have to grant more securities

8. The accounts and the waterfall

The agreement will set the details for the funds flow and the waterfall payment. All the movements in accounts and the portfolio management and asset disposal will be ascribed to a specific account movement.

9. Ratios

The following ratios are commonly used:

- LTC (Loan to Cost) ratio: proportion of the outstanding principal under the facilities must bear the total acquisition costs.
- EBITDA/Total Revenues covenant
- Minimum equity ratio: It measures the leverage used by the company comparing the part financed by stockholders opposed to the part financed by creditors.
- Loan to value and equity cure: It compares the amount of the mortgage with the valued amount of the property. It includes an equity cure in the event of breach of this ratio or in the event of payment default.

10. Possible limited recourse provisions

Sometimes, the sponsor may ask for a provision by which the obligation of the lenders against the obligors is limited to the security assets through which the transaction securities are created.

II. The guarantees: Certain Spanish law restrictions

In this part, intra group guarantees are especially important. Spanish law is not particularly restrictive in terms of intra group guarantees.

Those guarantees become questionable in an insolvency scenario as they might be detrimental to the estate and be rescinded. Although this can happen, insolvency is not an imminent risk because an event of default entitling the lenders to accelerate and enforce other transaction securities over the parent's shares will occur before insolvency proceedings are started.

III. The security package

1. The transaction security

Both parties of the agreement will agree on the securities that will be created to secure the facilities. The facilities can be properties, portfolio loans and rights, bank accounts and shares.

And depending on the underlying asset the securities will be mortgages, pledges, assignments, or security interests.

2. Enforcement of Spanish shares and bank account pledges

Pledges over bank accounts located in Spain will be subject to Spanish law. The pledges need to be documented.

Pledges over Spanish shares should also be subject to Spanish legislation. Non listed shares might also be pledged under the regime applicable to financial collaterals. Share pledges may be enforced through a Spanish notary public and no judicial proceedings are mandatory.

IV. Financing through securitization

Financing NPLs portfolio acquisitions through securitization is possible in Spain because it provides a structure to easily transfer NPLs portfolios.

Since the beginning of 2019, any securitization must comply with European Parliament Regulation and of the Council ("CRR[11]") governing recognition of significant risk transfer.

According to that regulation, NPLs can be securitized in two ways:

[11] CRR: Capital requirements regulation

i) Direct bank securitization where the originators sells all or part of the NPL to a securitization vehicle which issues securities and places them with third party investors.

ii) Portfolio sales to non-bank investors in which the originator sells directly NPLs to non-bank investors who purchase it and then it is securitized keeping an equity stake

At Spanish level, with the inclusion this new regulation, some amendments will be made to existing legislation (Law 5/2015) although the structure will continue being the SPVs[12] used for securitization transactions represented by a manager.

1. Spanish securitization vehicles

"Fondos de Titulación" (FTs) are a type of Spanish SPV regulated under Law 5/2015. FT are separate funds without legal personality and are represented by a manager. Managers must be Spanish public limited companies supervised by Securities Market Comission ("CNMV"). [13]

Securitization managers are bound by the obligations set in Law 5/2015 among which are included: using their best endeavors and acting transparently in defending the interests of securities holders and lenders.

FT assets consist on present and future receivables assigned by the seller. Meanwhile, FT liabilities may comprise any fixed income securities issued by the FT and loans provided by third parties.

The general requirements for setting up a FT are:

i) Application to create the FT, filed by the manager and submitted to the CNMV
ii) Registration at the CNMV
iii) Preparation of reports by the manager, auditor, or other expert
iv) Approval by the CNMV of a prospectus on the creation of the FT

When a FT is created, the originator remains being the lender of record and the FT is the beneficial owner of the receivables and credit claims arising from the NPL portfolio. Investors acquire indirect entitlement and full economic exposure to the NPL portfolio.

[12] SPVs: Spanish securitization vehicles
[13] CNMV: Comisión Nacional del Mercado de Valores

2. Transfer of NPLs or re-performing loan portfolios to an FT

As a general rule, to transfer NPL to an FT, assignors must submit audited financial statements for the past two fiscal years. If the audited financial statements include some qualifications, the CNMV might not allow the transaction.

Moreover, the CNMV also exempts the assignors to submit financial statements if the securities to be issued by the FT will not be traded on an official secondary market or if the assets to be transferred are guaranteed by the central, regional or local governments.

Mortgage loans can be assigned by issuing mortgage bonds ("PH")[14] or mortgage transfer certificates ("CTH[15]"). Those securities can only be issued by Spanish financial institutions.

3. Other advantages of FTs

3.1 Bankruptcy remote vehicles

a) Since FTs represent separate capital and do not have their own legal personality, they do not fall under Spanish bankruptcy rules.
b) Asset acquisitions by FTs can be only subject to claw back actions if the insolvency manager to the party that transferred such assets to the FTs evidences that the transaction was fraudulent
c) FTs have the right to have the PHs, CTHs or NPLs separated from the insolvency estate meaning that FTs can claim their interest in the loans as their own asset, not that of the PH or CTH issuer
d) In addition, FTs are entitled to obtain, through their managers, the funds the issuer collects from the loans
e) Finally, in case of insolvency proceedings against the manager, the manager must be replaced, and the FT will have the assets it owns but separated from the insolvency estate.

3.2 Tax neutrality of FTs

a) Only taxes on asset transfer can be applied
b) Corporate can be reduced almost totally
c) There is no withholding tax

[14] PH: Participaciones hipotecarias
[15] CTH: Certificados de transmisión hipotecaria

VIII. ALTERNATIVE STRUCTURES FOR DISVESTING DISTRESSED ASSETS

Traditional transactions such as company acquisitions have a different shape when the companies acquired are in a distressed situation. New structures as FABs ("Fondos de Activos Bancarios") have been newly created.

I. Share deals as an alternative structure for NPLs and REOs portfolio sales

NPLs or REOs might be transferred by direct sales or can be structured as share deals in which the seller contributes the assets to a newly incorporated or acquired company and then transfers ownership of that company as a whole to the purchaser.

The underlying loan and/or REO portfolio may be contributed through a share capital increase, with the creation of new shares subscribed through the contribution of loans/assets, or "other shareholder contributions" that do not entail the issue of new shares but a contribution made for no consideration.

One of the advantages of share deals when selling REO or loan portfolios is that the process of registering title over the mortgage loans or the REOs in the Spanish Land Registry can be started in the period between signing the SPA and closing. On the other hand, this structure makes it harder to form the portfolio, since corporate transactions are required to exclude any assets.

As regards to the due diligence and documentation, a share deal portfolio sale due diligence would not extend to the vehicle (target company) because it is not a pre-existing company, but rather incorporated by the seller after signing the SPA. The SPA will establish how the purchaser will monitor the seller incorporation of the target company.

II. Post-acquisition restructuring of portfolio acquisitions

In a portfolio acquisition structured as a share deal, the target company would typically be a Spanish company.

Since the objective is a true sale transfer of the portfolio to a company within the jurisdiction in which the purchaser operates, some parties have attempted to transfer risk and rewards through pure intragroup private agreements.

In a total spin off, the target company will disappear after restructuring is complete. Meanwhile, if the transfer is global, the assets and liabilities will be assigned to the target company shareholders or to third parties, and the target company will remain existing. In a total segregation, the target company's assets and liabilities would be transferred and, in exchange, the segregated company would receive shares of the beneficiary.

Another alternative for relocating assets in the post-closing group structure is an in-kind contribution, considering that the target company will form part of the purchaser's group. Therefore, the shareholders of the target company could contribute such company's shares by a capital increase, creating new shares or by "other shareholders contribution". As an alternative to contributing target company shares to another company in the purchaser's group, the target company assets could be distributed. The distribution can only be performed if the target company has sufficient reserves or profits and the assets can only be distributed to the target company's shareholders in proportion to their ownership interests.

III. Joint venture model as an alternative to complete disposal of distressed assets

Portfolio sales have been a useful solution for divesting assets considered as toxic. But, alternatively, some credit institutions are opting now for joint venture structures in which the credit institution remains a minority non-controlling partner and an investor acquires the majority stake of the portfolio and manages it.

1.Definition of the scope of the transaction and of the investment or framework agreement

A joint venture can be the result of a bilateral arrangement or a competitive process. The parties must agree how the partner owning the assets will restructure the ownership before the transaction is executed. Another consideration is whether assets transferred under joint venture models could be considered as an independent economic unit for being not subject to value added tax. To classify as such, assets must make up an independent economic unit for the transferor.

In terms of documentation, instead of using a SPA, the parties could enter into an investment or joint venture agreement. Such agreement regulates the business in which the partners co invest, the contributions and the transaction timeline and steps.

2. Conditions precedent

Depending on the volume, the transaction may be subject to merger control at European or Spanish level. Moreover, if one of the partners is a credit institution, mergers, spin offs, global assets and liabilities transfers or any other transaction with the same legal or economic effects must be authorized by the Spanish Ministry of Economy and Business.

3. Relationship between the contributing credit institution and the investor as a joint venture partner

As in any joint venture, the partners must design a structure in which the minority shareholder has say in key business decisions and representation on the board with certain matters requiring its presence and vote.

In case of a joint venture created so that a credit institution can divest assets, too much control would prevent the bank for cleaning up its balance sheet. Its interest in being an active part and having decision making power vis a vis the majority shareholder must be balanced with the asset de recognition requirements.

If the credit institution considers some of the disposed assets to be important, the partners can repurchase the asset after a certain period of time.

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